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C O N F I D E N T I A L SECTION 01 OF 03 ANKARA 003896

SIPDIS

SENSITIVE

TREASURY FOR INTERNATIONAL AFFAIRS - JROSE AND MNUGENT

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TAGS: EFIN TU
SUBJECT: MANAGING TURKISH MARKETS AND MEETING WITH TREASURY UNDER SECRETARY

REF: A. ANKARA 3644

¶B. ANKARA 3717

Classified By: Economic Counselor Tom Goldberger for reasons 1.4 (b) an d (d).

This cable was coordinated with Congen Istanbul.

1.(C) Summary: Turkish Treasury Under Secretary Canakci said that in GOT internal deliberations Turkish financial officials are conscious of the domestic factors in the recent market sell-off. Canakci pointed to the recent, relatively successful Central Bank actions that had given the markets the best week since the sell-off began. Bankers and regulators have yet to see signs of problems in the banking sector other than an expected reduction in profits. Turkish ministers are likely to continue to make market-unfriendly public statements, given domestic political considerations. End summary.

Treasury Under Secretary Appreciates Feedback

¶2. (C) In a meeting with Turkish Treasury Under Secretary Ibrahim Canakci on June 30, we passed on some of the concerns foreign investors had been expressing: Turkish officials not acknowledging the domestic factors in the sell-off and the impression that the Central Bank and Government were not well-coordinated in their actions and public statements.

¶3. (C) Canakci said he had been hearing similar comments from &everyone we talked to8 in recent days. On the first point, he said that in internal deliberations Turkish officials are very conscious of the domestic factors in the market sell-off. Canakci said he believes the most important domestic factor was the pick-up in inflation that drove up interest rates and hurt prices of equities and fixed income government securities, causing non-resident portfolio investors to pull out of Turkish securities. Canakci also recognized the role of political factors, including the shooting of a judge, tensions between the opposition and government and problems with the EU, but said &these are not directly related to us.8

¶4. (C) At the same time Canakci said the change in the Central Bank Governorship had caused a kind of &pause in monetary policy.8 Admitting the monetary policy was &a little lagged8 he nevertheless believed that the policy response ultimately had been strong. In addition to the Bank,s moves on interest rates and in markets, the Government had accelerated structural reforms and taken new measures to strengthen its debt and cash management position (see para 13).

¶5. (C) Canakci said statements were ineffective if not backed by strong actions. In this kind of turbulent market, only strong actions will change investors, mood. He lamented actions had sometimes been taken in bits and pieces. He also expressed frustration about Ministers, like Finance Minister Unakitan, making comments about inflation. He also said the Governor,s newness may have contributed to missteps on communication.

¶6. (C) Canakci went into some detail about coordination mechanisms with the Central Bank below the ministerial level. He told us he attends the first part of the Monetary Policy Committee meetings and presents Treasury,s view of current conditions, as does the Central Bank,s staff. Then the staff and he leave for the decision-making part. He also pointed out that his staff and the Central Bank Markets Department meet regularly to coordinate Treasury,s debt strategy with the Bank.

¶7. (C) As before, Canakci downplayed the significance of the current account deficit, which he sees as largely reflecting external savings being used to finance investment in Turkey. He said that the current account deficit to GDP ratio roughly approximates the investment to GDP ratio over the past 3 or 4

years. He pointed to substantial capital goods imports and large FDI flows to reinforce this point.

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Stabilized Markets Await June Inflation Numbers
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¶8. (SBU) Our call on Canakci came at the end of Turkish markets best week since the turbulence began around May 9. The Central Bank,s package of actions Sunday and Monday (a rate hike, foreign exchange auctions and intervention, and beginning lira deposit auctions) stopped and then reversed the slide in the lira. Helped by Turks having to pay their taxes (which always reduces lira liquidity) and a further hike in the overnight lending rate Wednesday, the exchange rate in particular, and markets in general remained stable all week. On Friday, the better-than-expected Fed decision and statement sparked a global rally that included Turkey, driving the lira to 1.57, its best level in over a week. The exchange rate continued to trade around this level on Monday, as markets awaited the June inflation data. In the event, the inflation data was not out of line with expectations, with the CPI better than expected and the PPI worse.

Disconnect between Resident and Non-Resident Investors

¶9. (C) London- and New York-based investors have expressed concerns about Turkey,s market problems and how they were being managed. Merrill Lynch,s Turkish economist (protect) told us he had been telling Minister Babacan that the Bank should be intervening in the foreign exchange market (although the IMF was advising the Bank not to intervene so frequently). He brushed aside doubts that it was appropriate to talk to Babacan about what the Governor should do, joking that &they practically live together.8

¶10. (C) In a strikingly consistent pattern, however, local observers seemed much less concerned than foreign investors. Turkish big business leaders have been telling Congen Istanbul that they are not particularly worried, and have not repositioned their businesses or holdings. They say some smaller businessmen have done so, but it,s not that significant. The expatriate manager of Citigroup,s Turkish subsidiary expressed frustration over how much more concerned his people in New York seemed than anyone he was talking to in Turkey, including the IMF Resrep. A visiting USDA bank analyst found Fitch,s Istanbul rep (the only rating agency analyst based in Turkey) rather balanced in her view. Fitch even upgraded Garanti Bank during the week, although S&P changed its outlook on Turkey from stable to positive.

¶11. (SBU) Bankers in Istanbul told Congen Istanbul that retail investors had not moved out of lira during the sell-off, much as the CFO of Ziraat Bank told us her bank had experienced no movement out of lira deposits. The Istanbul bankers did say some Turkish corporates who had borrowed in foreign exchange sold lira when the exchange rate hit 1.7 but that has now stopped. Perhaps reflecting the far less anguished mood locally, Bear Stearns Turkey analyst switched from a relatively pessimistic stance to a buy recommendation after a week in Turkey.

No Signs Yet of Banking Sector Problems

¶12. (SBU) A series of meetings with bankers in Istanbul and Ankara, as well as with the Bank Regulatory and Supervisory Agency(BRSA) and the Central Bank Banking Department suggests there are no signs yet that rising interest rates and a falling lira are causing significant problems in the banking sector. Though the BRSA Vice-Chairman admitted it was too soon to say whether corporate open positions are severe enough to cause problems in the banking sector (through non-performing loans), the regulators are fairly confident regarding other banking sector vulnerabilities. Knowing the banks, end-May balance sheets, for example, the regulators have been able to calculate the impact of the interest rate and exchange rate moves and see no sign of significant problems, although banks profits will certainly take a hit. To be on the safe side, the Chairman of BRSA will begin bank-by-bank meetings with CEO,s to go over each bank,s situation. The Central Bank voiced similar confidence based on its analysis and stress testing, and the Ziraat bank CFO described in detail how the bank,s strengthened financials have positioned it to weather the current problem.

Treasury Confident on Debt Situation

¶13. (SBU) Having beefed up its reserves, lowered its rollover ratio, and reduced the share of its debt denominated in) or

indexed to foreign exchange -- Turkish Treasury is not too worried about the impact of the sell-off on its debt position. Treasury has had to take a break from its efforts to lengthen its maturities, given the absence of market appetite for long-dated paper but this effort was long-term, not an immediate need. Canakci told us Treasury had accelerated efforts to collect non-debt creating inflows such as the proceeds of State Deposit Insurance Fund asset sales and privatization receipts. He said Treasury has also redoubled its focus on cash management, only transferring funds to line ministries when the ministries really need them so as to maximize Treasury reserve levels.

Fiscal Impact Unclear

¶14. (SBU) Of all the impacts from the recent sell-off, perhaps the most uncertain is on the Government,s fiscal balances. The lower exchange rate and higher inflation will cause increased costs for public sector spending on everything from pharmaceuticals to higher interest costs. Given lower-than-expected borrowing needs, however, the interest rate cost may not be too severe. On other spending, the recent IMF mission had been particularly focused on controlling spending and had worked with the Government to implement additional measures, such as passing on more of the cost of pharmaceuticals to patients. On the revenue side, the state had been collecting more revenue than projected, which may help offset the expected slowdown in revenue growth if, as expected economic growth slows dramatically in the second half. As Erdogan, Unakitan and Babacan have repeatedly stated, the Government is determined to demonstrate a continued commitment to fiscal discipline. On July 3, Reuters reported an unnamed Turkish official saying the GOT would increase the primary surplus target in 2006 from 6.5% to 6.7% -- an extraordinary undertaking given that the weaker lira and higher interest rates make it harder to realize even the 6.5% target.

Comment:

¶15. (C) The relative lack of worry about banks or the state debt situation could change if market negativity leads to further exchange rate depreciation and interest rate increases. Hence the continued need for improved coordination, strong actions and better communication on the part of both Government and Central Bank. In terms of the Government,s communication, Canakci,s frustration with Unakitan speaks to a larger issue, that the economic technocrats, including Babacan, will not be able to control. On narrowly economic policy issues, the GOT, including PM Erdogan, continually reiterates its commitment to the reform program. However, it would help markets if Turkish ministers toned down their rhetoric, including on problems with the EU. But Turkish politicians will respond in a manner that plays well to a domestic audience rather than to investors.

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